24 September 2018

INSTEM

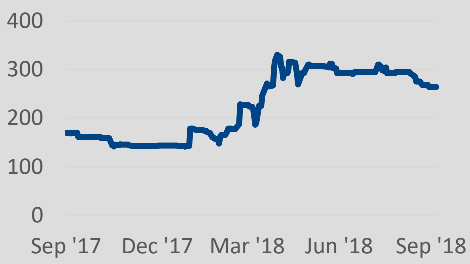
SOFTWARE AND COMPUTER SERVICES

INS.L

300p

Market Cap: £47.7m

SHARE PRICE (p)



12m high/low	330p/141p

Source: LSE Data

KEY INFORMATION

Enterprise value	£44.6m
Index/market	AIM
Next news	T/U Jan-19
Gearing	N/A
Interest cover	N/A

INSTEM IS A RESEARCH CLIENT OF PROGRESSIVE

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Strong margins and cash performance

Instem has reported interim results consistent with the July trading statement. Revenue grew to £10.5m, with outsourced services revenues more than trebling to £1.1m. Margin performance was strong (opex fell 6% YoY) and cash generation solid. Net operating cash inflow saw a £3m turnaround to £1.9m and the closing net cash balance was confirmed at £3.7m. Delivery seems to have been strong across the board, with particular strength in SEND. We leave estimates unchanged following the release and believe H1 2018 results provide grounds for optimism regarding the H2 and beyond.

- **Strong margin performance:** EBITDA more than doubled YoY in H1 2018 to £1.4m, and Opex saw a 6% decline YoY. This was a function of an improved sales mix, with results also seeing the benefits of the organisational restructuring undertaken in mid-2017.
- **Solid cash generation:** H1 2018 saw operating cash inflow of £1.6m, versus an outflow of £1.4m in the comparable period. This was a function of increased cash inflow from key contracts and outsourced services, along with a received R&D tax credit. Closing net cash was confirmed at £3.7m, boding well for our £4.9m year-end estimate.
- **Regulatory Solutions business continues to deliver:** SEND performance remains strong. Management believe the group continues to win the majority of new business placed in SEND technology and outsourced services. During H1 2018, Instem won a £1.7m contract (over two years) with a global top five non-clinical Contract Research Organisation ("CRO") outsourcing all of its SEND dataset generation. A top five pre-clinical CRO also extended its outsourced services contract to over US$0.5m. Overall, SEND services orders more than trebled in number compared to the prior year.
- **Positive outlook:** Management were "very pleased" with the performance of the business during H1 2018. For the second half, technology-enabled outsourced service contracts won during H1 2018 are expected to be a key driver of revenue growth. The group also reported impressive growth in Asia, with bookings up 60% YoY and this momentum is expected to continue into the second half.

We make no changes to forecasts at this stage, but note the positive outlook statement and the business's inherent seasonality - second half performance has traditionally been stronger than the first, although as we show overleaf, this year's H2 "requirement" appears less of an ask than in prior years…a very reassuring state of affairs.

FYE DEC (£M)	2016	2017	2018E	2019E	2020E
Revenue	18.3	21.7	23.0	25.2	27.4
Adj EBITDA	1.3	3.0	3.6	4.5	5.0
Fully adj PBT	0.5	2.2	2.6	3.4	3.8
Fully adj EPS	2.0	10.1	11.5	15.3	17.0
EV/Sales	2.4	2.1	1.9	1.8	1.6
EV/EBITDA	35.6	15.1	12.5	9.8	8.8
PER	148.5	29.8	26.1	19.6	17.6

Source: Company Information and Progressive Equity Research estimates

Management continues to deliver on the strategy

In our view, Instem's H1 2018 results demonstrates that management continue to deliver on the group's strategy.

At the 2017 Investor Teach In event (*London,07/03/17*) a three-point strategy was communicated:

- Extend technology leadership through continued investment in products and services across traditional markets, consolidating the industry
- Maximise the opportunity in SEND services
- Make further progress on developing Artificial Intelligence ("AI") enabled informatics solutions.

We believe the following points provide ample evidence of delivery:

- SaaS bookings grew 98% YoY during H1 2018, with deployments building momentum for both new client implementations and existing customer upgrades. The group also recorded a contract win with a Fortune-500 client for Samarind RMS. (*Technology leadership*)
- H1 2018 saw significant growth in order volumes for technology-enabled SEND services – 75 vs 23 in H1 2017, with Instem continuing to win the majority of new business placed in SEND technology and outsourced services. *(Maximise SEND opportunity)*
- KnowledgeScan, the group's informatics-based service for investigating safety concerns in drug development, saw 15% YoY growth in new orders, mainly from repeat customers.

On track for FY 2018E expectations

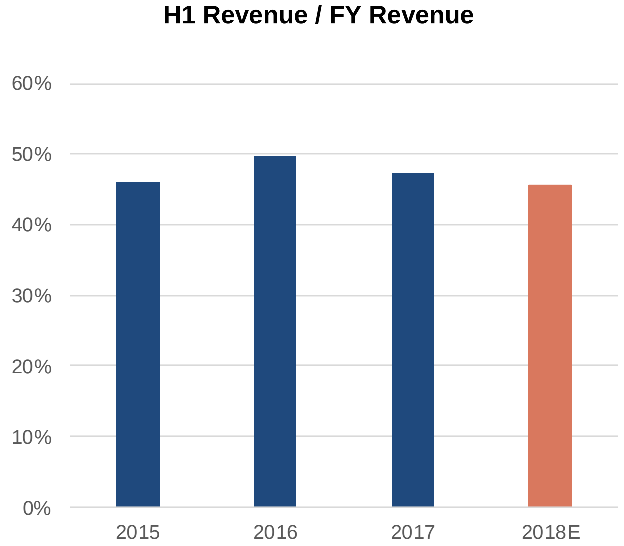
We believe Instem's H1 2018 results demonstrate the business is firmly on track to deliver our FY 2018E estimates. In the first half, Instem has delivered 46% and 39% of our respective FY 2018E revenue and EBITDA forecasts, both of which compare favourably with historic levels. The following points support our positive stance:

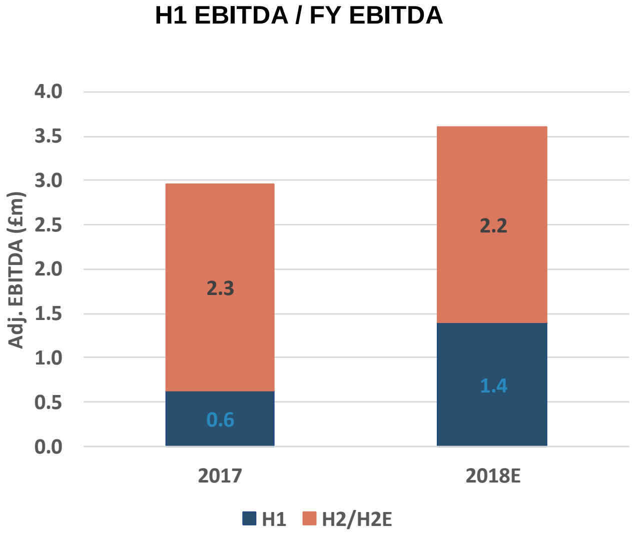
- Instem has historically demonstrated seasonality in revenues, with the second half usually being slightly ahead of the first. This has been a stable trend over recent reporting periods – the group has delivered between 46% and 50% of FY revenues in the first half (46% FY 2018E)
- With the exception of FY 2016 where specific issues in the Clinical business impacted second half performance, the trend for EBITDA is more pronounced. Excluding 2016, Instem has reported between 20% and 36% of FY EBITDA in the first half over recent years. For 2018E, on our estimates, Instem has already delivered some 39% of the 2018E total)

Based upon our FY 2018E forecasts, Instem has delivered H1 2018 revenues as a percentage of the full year outcome in line with historic levels, with EBITDA some way ahead of the recent historic average level. In our opinion this bodes well for the second half.

The charts on the next page demonstrate the contribution of H1 revenue and EBITDA to the respective full-year outcomes over recent reporting periods.

Instem – H1 revenue and EBITDA vs full-year outcome 2015 - 2018E





Source: Company data

Market highlights

Order volumes in **Study Management and data collection** were "generally solid" during H1 2018, particularly for Provantis, the group's preclinical software suite.

Across the board, there was a transition with the business moving away from fewer, but higher value contracts towards higher volumes of smaller value deals; we believe this transition bodes well for ongoing growth, and also lowers earnings risk. Renewal rates remained "very high", which is positive given that Study Management activities contribute the bulk of Instem's recurring revenues. One particular on-premises client moved to SaaS delivery alongside an upgrade to Provantis version 10.

H1 2018 saw impressive growth in KnowledgeScan, the group's **informatics**-based service for investigating safety concerns in drug development, which saw 15% YOY growth in new orders, mainly from repeat customers.

In the **Regulatory Information Management** business**,** H1 2018 saw a significant contract win for Samarind RMS with an unnamed Fortune 500 customer. The client has adopted the platform for its global medical products regulatory tracking system. The contract contains both SaaS and perpetual license elements with a total value of cUS$750k, 80% of which will be recognised in 2018 financials and with a $169k recurring revenue stream.

A feature of recent results releases from Instem, the **SEND** business continues to perform strongly. Management believe the group continues to win the majority of new business placed in SEND technology and outsourced services, with SEND contract value in H1 2018 exceeding the whole of 2017.

As previously discussed, SEND profit margins in 2017 were dampened by in-house sales of a third-party product called SEND Explorer. The sales mix has now moved more towards Instem's own products, resulting in a higher level of margin on SEND revenues.

As a result of the ongoing momentum in SEND (note the near-trebling of contract wins during the first half), Instem has upsized its outsourced services team with the recruitment of an additional 27 staff (of which 19 were in India). With a potentially vast opportunity for SEND services (a c.US$120m addressable market annually by 2020 according to management[1]), we believe the investment is entirely logical, and represents an investment in future growth. It is pleasing to see that this level of capacity expansion can still be achieved while delivering on strong profit growth in the short term.

A solid half year, and opportunities remain

The H1 performance, as described above, provides the group with a very solid platform for delivery of our (and consensus) estimates for the full year. Revenue is tracking to historic patterns, and the H2 required EBITDA result appears highly achievable, when compared to prior years, and given the normal seasonality in the business.

Further, the group has achieved this strong result despite ongoing investment in, and growth of, its capacity – across the group, but especially in relation to SEND and SEND services, where there appears to be clear growth already being achieved, but very material scope for further expansion given the scale of the relevant markets.

Overall, H1 2018 is a strong signal of current performance, but also bodes very well for medium and longer-term delivery.

[1] See FY 18E has started well, SEND accelerating: PERL 23/07/18 for further analysis of the SEND market opportunity

Financial Summary: Instem

Year end: December (£m unless shown)

PROFIT & LOSS	**2016**	**2017**	**2018E**	**2019E**	**2020E**
Revenue	18.3	21.7	23.0	25.2	27.4
Adj EBITDA	1.3	3.0	3.6	4.5	5.0
Adj EBIT	0.7	2.3	2.6	3.4	3.8
Reported PBT	0.0	0.8	1.6	2.4	2.8
Fully adj PBT	0.5	2.2	2.6	3.4	3.8
NOPAT	0.5	1.7	1.9	2.6	2.8
Reported EPS	6.8	6.8	6.0	9.4	10.8
Fully adj EPS	2.0	10.1	11.5	15.3	17.0
Dividend per share	0.0	0.0	0.0	0.0	0.0
CASH FLOW & BALANCE SHEET	**2016**	**2017**	**2018E**	**2019E**	**2020E**
Operating cash flow	1.3	1.9	3.8	4.5	5.2
Free Cash flow	(0.2)	0.1	2.0	2.4	2.9
FCF per share	(1.2)	0.6	11.9	14.1	17.5
Acquisitions	(3.3)	(0.7)	(0.2)	0.0	0.0
Disposals	0.0	0.0	0.0	0.0	0.0
Capex	(1.0)	(1.6)	(1.3)	(1.3)	(1.3)
Shares issued	4.8	0.0	0.0	0.0	0.0
Net cash flow	1.3	(0.8)	1.8	2.4	2.9
Cash & equivalents	4.2	3.1	4.9	7.2	10.2
Net (Debt)/Cash	4.2	3.1	4.9	7.2	10.2
NAV AND RETURNS	**2016**	**2017**	**2018E**	**2019E**	**2020E**
Net asset value	12.8	14.2	18.0	19.5	22.4
NAV/share	82.0	91.2	115.2	125.2	143.3
Net Tangible Asset Value	(4.8)	(3.2)	1.3	3.8	5.5
NTAV/share	(30.9)	(20.6)	8.2	24.2	35.4
Average equity	9.7	13.5	16.1	18.7	20.9
Post-tax ROE (%)	10.9%	8.1%	6.3%	8.4%	8.7%
METRICS	**2016**	**2017**	**2018E**	**2019E**	**2020E**
Revenue growth	12.2%	18.3%	6.4%	9.4%	8.6%
Adj EBITDA growth	(50.0%)	136.4%	20.5%	27.5%	10.9%
Adj EBIT growth	(63.7%)	221.2%	11.4%	33.2%	10.8%
Adj PBT growth	(73.5%)	381.4%	18.6%	33.2%	11.0%
Adj EPS growth	N/A	N/A	14.1%	33.2%	11.0%
Dividend growth	N/A	N/A	N/A	N/A	N/A
Adj EBIT margins	3.9%	10.6%	11.1%	13.5%	13.8%
VALUATION	**2016**	**2017**	**2018E**	**2019E**	**2020E**
EV/Sales	2.4	2.1	1.9	1.8	1.6
EV/EBITDA	35.6	15.1	12.5	9.8	8.8
EV/NOPAT	88.9	25.8	23.2	17.4	15.7
PER	148.5	29.8	26.1	19.6	17.6
Dividend yield	N/A	N/A	N/A	N/A	N/A
FCF yield	(0.4%)	0.2%	4.0%	4.7%	5.8%

Source: Company information and Progressive Equity Research estimates

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